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Supreme Court, U.S.
FILED
MAY 9 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 94, Original

IN THE

Supreme Court of the United States

October Term, 1986

STATE OF SOUTH CAROLINA,

Plaintiff,

NATIONAL GOVERNORS' ASSOCIATION,

Plaintiff-in-Intervention,

v.

JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,

Defendant.

EXCEPTIONS OF THE NATIONAL GOVERNORS' ASSOCIATION TO THE REPORT OF THE SPECIAL MASTER AND BRIEF IN SUPPORT THEREOF

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EXCEPTIONS OF THE NATIONAL GOVERNORS' ASSOCIATION TO THE REPORT OF THE SPECIAL MASTER

I. EXCEPTIONS TO THE REPORT OF THE SPECIAL MASTER

On August 16, 1984, the Court appointed the Honorable Samuel J. Roberts, retired Chief Justice for the Supreme Court of Pennsylvania, as its Special Master for the purpose of this action. Following an extensive presentation of evi-

dence, the Special Master reached his conclusions and made recommendations in a Report* submitted on January 22, 1987 and ordered filed on February 23, 1987. The National Governors' Association, which the Special Master recommended that the Court permit to proceed as plaintiff-in-intervention, takes exception to the Special Master's report in the following respects:

EXCEPTION NO. 1

Plaintiff-in-intervention takes exception to the finding of the Special Master that Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") does not contravene "affirmative limits" upon Congress' regulatory authority found in the Tenth Amendment. These limits are built into the structure of the federal Constitution, which establishes a national government, but recognizes the "separate and independent" existence of the States. The Master reached this conclusion by assuming, erroneously, that the Constitution required examination of the weight rather than the nature of Congress' intrusion on the States' internal government imposed by Section 310(b)(1).

EXCEPTION NO. 2

Plaintiff-in-intervention takes exception to the finding of the Special Master that no interest rate differential exists between registered and bearer bonds. The Master incorrectly concluded that there was no interest penalty on registered bonds by failing to credit a secondary market study by the

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* Hereinafter the Special Master's Report will be referred to as "Report"; the Stipulation of Facts entered into by the parties will be referred to as "Stip."; the Trial Transcript will be referred to as "Tr."; the Plaintiffs' Exhibits will be referred to as "PX."

Secretary that revealed this interest rate differential. (Report at 70). In fact, the Secretary's study, as noted by both the plaintiffs and defendant, was meticulously constructed and methodologically sound. Once the errors in data had been corrected, the Secretary's study, which revealed an interest penalty, should have been accepted by the Master.

Respectfully submitted,

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JAMES A. BAKER, III, SECRETARY OF THE TREASURY OF THE UNITED STATES OF AMERICA,

Defendant.

BRIEF IN SUPPORT OF EXCEPTIONS TO THE REPORT OF THE SPECIAL MASTER

QUESTION PRESENTED

Whether Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act ("TEFRA"), which in effect required states and local governments to use their legislative and administrative power to satisfy a federal directive, interfered with the States' separate and independent existence in violation of the principles of federalism expressed by the Tenth Amendment?

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STATEMENT OF JURISDICTION

The original jurisdiction of the Court was invoked by South Carolina under Article III, Section 2, Clause 2 of the Constitution of the United States.

CONSTITUTIONAL PROVISION AND STATUTE INVOLVED

The Tenth Amendment to the Consitution provides: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

Section 310(b)(1) of TEFRA, 26 U.S.C. §103(j) (1982) provides:

> **(j) Obligations must be in registered form to be tax-exempt.**
>
> **(1) In general**
>
> Nothing in subsection (a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any registration-required obligation unless the obligation is in registered form.
>
> **(2) Registration-required obligation**
>
> The term "registration-required obligation" means any obligation other than an obligation which -
>
> (A) is not of a type offered to the public,
>
> (B) has a maturity (at issue) of not more than 1 year, or
>
> (C) is described in section 163(f)(2)(B) [26 U.S.C. § 163(f)(2)(B)].

(3) Special rules

(A) Book entries permitted

For purposes of paragraph (1), book entry obligation shall be treated as in registered form if the right to the principal of, and stated interest on, such obligation may be transferred only through a book entry consistent with regulations prescribed by the Secretary.

(B) Nominees

The Secretary shall prescribe such regulations as may be necessary to carry out the purpose of paragraph (1) where there is a nominee or chain of nominees.

PRELIMINARY STATEMENT

This is a challenge to the constitutionality of Section 310(b)(1) of TEFRA, which requires the registration of all municipal bonds. Congress enacted Section 310(b)(1) because of concerns that bearer bonds were being used for tax evasion purposes. Plaintiff National Governors' Association ("NGA") challenged Section 310(b)(1) on the grounds that it violated the Tenth Amendment and principles of federalism inherent in the structure of the Constitution.*

* Plaintiff State of South Carolina challenges Section 310(b)(1) on the ground that the Section's threatened withdrawal of the tax exemption for failure to register violates the doctrine of intergovernmental tax immunity. As discussed, *infra*, the NGA believes the tax immunity issue no longer is presented in this case. Nevertheless, if the Court reaches the issue, the NGA fully supports South Carolina's position that the exemption is constitutionally mandated.

Several points should be noted at the outset. First, the NGA fully supports any Congressional action carefully crafted to address tax evasion. It is in the best interest of the States to see that federal tax evasion is curbed both because the amount of federal revenues frequently determines the monies available for state use and because many states premise their tax collection on federal returns. It is the NGA's position, however, that the manner in which Congress addressed its tax evasion concerns was improper; eschewing more effective methods solely within federal means, Congress employed state governments to address federal concerns.

Second, it is the NGA's position that the Special Master erred in finding Section 310(b)(1) constitutional by mistakenly examining only the weight of the federal intrusion when it is the nature of that intrusion that causes constitutional concern. Section 310(b)(1) had the effect of requiring state and local governments to pass legislation and devote substantial administrative resources to the federal end, diverting those governments from their own agendas. The Master, by and large, accepted the facts as to each of the intrusions offered into evidence by the NGA. But, he upheld the statute, finding that those intrusions imposed a burden the weight of which was "neither trivial nor extraordinary." (Report at 40).

As set out in full below, it is the NGA's position that in assessing the constitutionality of Section 310(b)(1) this Court should focus on the nature of the intrusion into state governmental processes. The question presented in this case is whether it is within Congress' authority to co-opt state governmental processes to reach an end that Congress itself could achieve.

STATEMENT OF THE CASE

On February 7, 1983, South Carolina sought leave to file an original complaint in the United States Supreme Court challenging the constitutionality of Section 310(b)(1). South Carolina contended that the Section violated the Tenth Amendment to the United States Constitution and that the loss of the federal income tax exemption for interest paid on the debt constituted a penalty that violated the doctrine of intergovernmental tax immunity inherent in the federal system.

This Court granted leave to file the original complaint on February 22, 1984. *South Carolina* v. *Regan*, 465 U.S. 367 (1984). The Court believed that South Carolina's complaint raised important federalism issues. Justice Brennan wrote for the Court that "[u]nquestionably, the manner in which a State may exercise its borrowing power is a question that is of vital importance to all 50 States." *Id.* at 382. Concurring, Justice Blackmun observed that the "issue presented is a substantial one, and is of concern to a number of States." *Id.* at 384. In addition to granting South Carolina's motion, the Court appointed a Special Master to develop a factual record.

Subsequent to the appointment of a Special Master, the National Governors' Association ("NGA") filed a motion for leave to intervene as a plaintiff. The NGA is an incorporated instrumentality of the States, the members of which are the chief executives of the fifty States, two Commonwealths and three Territories. Its purpose is to represent the States in the federal system. The NGA premised its motion to intervene on the ground that "[t]he States, Commonwealths and Territories whose chief executives are members of the NGA [would] be bound by the judgment and have a substantial interest in the outcome." *Motion of the National Governors' Association for Leave to Intervene as Plaintiff* at 2. The NGA

stressed to the Master that it would be able to provide the Court with a broad national perspective, drawing upon and demonstrating the impact of Section 310(b)(1) in the fifty states.* The motion was referred by the Court to the Special Master on August 16, 1984.

After briefing and oral argument, the Special Master recommended that the motion for leave to intervene be granted. This recommendation was premised upon the NGA satisfying certain conditions imposed to prevent duplication of proof at the hearing. Subsequently, the Special Master found that the NGA "met those conditions." Moreover, the Master found that "NGA's contribution to the fact-finding process has been substantial and has materially aided the Special Master in discharging his duties." (Report at 4 n.7).

The parties engaged in substantial discovery. Following discovery, three weeks of hearings were held before the Special Master. At those hearings, the plaintiffs introduced evidence as to the nature and extent of the federal intrusion into state and local government imposed by Section 310(b)(1) of TEFRA. The defendant, in turn, introduced evidence to show that despite these intrusions, there were certain benefits to registration ("market benefits") and that registration was justified by Congress' concern that bearer instruments were being used to avoid federal taxes ("tax benefits").

* The NGA was supported in its motion by the Academy for State and Local Government, the Council of State Governments, the International City Management Association, the National Association of Counties, the National Conference of State Legislatures, the National League of Cities and the United States Conference of Mayors.

The parties submitted proposed findings of fact and briefs on the merits in support of those findings. On the basis of the submissions, the Special Master found that Section 310(b)(1) did not impose burdens on the States the weight of which were sufficient to render the statute unconstitutional. The Master did not, however, address the question whether the very nature of the federal intrusion on state processes required by this statute made it unconstitutional.

STATEMENT OF FACTS

The municipal bond market is numerous and diverse, consisting of some 47,000 issuers of municipal bonds ranging in size from large states and public agencies to small towns and school districts. (Report at 20). Although the largest of issuers may issue several billion dollars worth of debt per year, seventy-six percent of issuers issue less than 10 million dollars per year. (*Id.* at 20-21).

Municipal bonds provide a critical source of funds used by state and local governments to meet the pressing needs of their citizens. Proceeds from municipal bonds most often are used to finance capital improvements for essential government functions. For example, in 1984 approximately $27 billion raised from general obligation bonds was spent building and maintaining roads, bridges, jails, schools and municipal buildings. Funds from municipal revenue bonds totalling $74 billion in 1984 were used for numerous functions such as water and sewage, hospitals, public power, pollution abatement, public housing, mortgage subsidies and student loans. (Stip., Para. 19).

Considerable state time, energy and money is devoted by state and local governments to the approval and issuance of municipal debt. The "importance of debt issuance to the

States is reflected in the detail in which state constitutions, statutes and ordinances prescribe the procedures by which debt may be incurred and issued." (Report at 77). The procedures and provisions vary widely from state to state and from issuer to issuer. States have, since the founding of the Union, valued their prerogative to shape the raising of revenue. All regulatory schemes generally mandate that the process remain under strict control of the citizens and their elected representatives. State constitutions generally require statewide referenda before issuance of debt obligations that are secured by the borrowers' full faith and credit. (Stip., Para. 19).

Until 1983 the 47,000 issuers of municipal bonds had one thing in common: their debt was issued almost exclusively in bearer form. (Report at 23). Bonds held in bearer form are negotiable instruments that are easily transferred. (*Id.* at 24). Congress, in requiring registration, was concerned that this ready negotiability led to tax evasion. *See infra* at 17. The record in this case shows, and the Master found, however, that the vast majority of bearer bonds are negotiated through brokers. (*Id.* at 85). These brokers have a legal obligation to report the transfers to the Internal Revenue Service ("IRS"). As a result, the tax evasion problem caused by the illicit negotiation of bearer bonds is significantly reduced. (*Id.* at 82).

Pursuant to Section 310(b)(1), as of July 1, 1983, all 47,000 issuers were required to stop issuing their debt in bearer form and switch to a system of issuing registered bonds. Section 310(b)(1) requires that municipal bonds be registered in order to maintain their tax-exempt status. (*Id.* at 1). Because forfeiture of tax-exempt status would increase the rate of interest state and local governments pay on their obligations by 28% to 35%, Section 310(b)(1) effectively

requires the registration of these municipal obligations. (*Id.* at 2).

Under a registration system, the issuer or its "transfer agent" maintains a registry of the record owners of registered bonds. (*Id.* at 24). Although beneficial ownership is a matter for negotiation, legal title can only be transferred by recording the change in the agent's books. Transfer of record ownership of registered certificated bonds occurs when the seller surrenders the old certificates to the issuer or to a transfer agent, who then updates the ownership records, cancels the old certificate, and issues a new certificate to the buyer. (*Id.* at 25). Requiring that the bonds be registered lessens their negotiability.

Even the fact-findings of the Special Master call into question the extent to which registration assisted tax authorities in addressing tax evasion. Of critical importance, the transfer agents required by registration to record transfers do not report bond transfers to the IRS, while brokers always did so. (*Id.* at 82). Moreover, registration is unhelpful for information reporting to the IRS. Its only benefit in preventing tax evasion is in providing a "paper trail" to be followed by IRS agents investigating tax fraud. Even this paper trail is of limited value, however, because the record owner on the books of the transfer agent need not be the real owner, who can remain anonymous by an arrangement that is not reflected on the transfer agent's books. (*Id.* at 26-27). Effective methods of preventing tax evasion are as important to the States as to the federal government. Unfortunately this statute does not provide such a method.

PLAINTIFF'S CASE: THE INTRUSIONS ON STATE AND LOCAL GOVERNMENT CAUSED BY REGISTRATION

The NGA offered evidence at trial through the testimony of state and local officials that the registration requirement impermissibly intruded on the States' sovereign functions in five ways. Except for the interest rate differential, the Special Master made findings consistent with the plaintiff's position as to each of these intrusions.

1. Legislative Costs

The NGA asserted, and the Special Master found, that Section 310(b)(1) required the States to pass numerous laws to comply with, and implement, the federal standard. Prior to the effective date of TEFRA, many state laws required that bonds be issued in bearer form or forbade their issuance in any other form. *Report of the Conference on Registered Municipal Securities* at 9 (Washington, D.C. October 18, 1982). Other state laws — such as those requiring authentic signatures on bonds — could not be adapted to a registration system and had to be amended. (Report at 38). In order to comply with TEFRA, these state laws and regulations, direct and indirect, had to be swept away. The Special Master observed that the "time and money expended to comply with TEFRA, both at the legislative and administrative levels, was not insignificant." (*Id.* at 36).

The NGA presented extensive evidence as to the legislative costs imposed on four representative states. (*Id.* at 36). The Special Master noted these examples. There is no dispute that this evidence is representative of the experience of the fifty states.

In New Jersey,* for example, forty-seven separate statutes had to be amended in order to comply with TEFRA. (*Id.* at 36). The coordination of the drafting and passage of the bills was tremendous, requiring the services of a lawyer in the Governor's office. (*Id.* at 37). The executive branch solicited advice as to the substance of the bills from investment professionals who developed drafts. (*Id.* at 37). A statewide committee became involved to ensure a smooth transition for local governments and authorities. (*Id.*). After several months of meetings, draft legislation was circulated to the many different interested parties. At the same time the executive branch had to work with the legislature to convince other legislators to withdraw legislation they had introduced, on the ground that parallel legislation would confuse rather than distill the necessary requirements. (*Id.* at 34). In Kansas,** eighty-six statutes had to be amended and three repealed; and in Michigan*** and Illinois,**** a similar diversion of state resources was required to comply with the registration requirement. (*Id.* at 38).

This experience, typical of the States, forced state officials to turn the time and resources of their state

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* Michael Horn, who at the time of trial was the State Treasurer of New Jersey, testified on plaintiffs' behalf. (Tr. 202-92).

** Robert Knight, a councilman and former Mayor of Witchita, Kansas, also supported NGA's case at trial. (Tr. 527-52).

*** Robert Bowman, the State Treasurer of Michigan, observed that considerable confusion was caused in the state legislature by the demands of TEFRA. (Tr. 674-754).

**** Governor Thompson testified for the plaintiffs, noting the obstacles that Illinois had to overcome to comply with TEFRA. (Tr. 355-97).

governments from other functions and priorities in order to meet the federal requirement.

2. Administrative Transition Costs

Effecting the transition to registration also imposed significant administrative burdens upon the States and their municipalities. Issuers who had not developed any expertise in issuing or marketing registered bonds now had only nine months to implement a working system. (Report at 38). Because Section 310(b)(1) mandated registration for all issuers, with no exceptions or provisions tailored to the size of the issuer or the problems the issuer might encounter, state and local governments had to organize numerous meetings and education sessions to ensure compliance. (*Id.* at 39). Responsible officials at the state and local level conferred, attended seminars and met with local bankers to develop administrative proposals to effect the transaction. (*Id.* at 39). In New Jersey, for example, several high-level members of the Treasurer's staff devoted substantial time to effecting registration, choosing transfer agents, re-evaluating bid procedures and accomplishing related tasks. (*Id.* at 39). In addition, the state had to hire eleven temporary employees and expend hundreds of hours of overtime to accomplish the myriad tasks associated with the transition. (*Id.* at 39).

Fifteen members of Michigan's Treasury staff spent as many as ten days away from routine duties. (Tr. 724). The experience was similar in New Jersey, Illinois and Kansas. (*Id.* at 40). Responsible officials were thus diverted from pressing state and local government business to attend to the transition to registration. As the Special Master observed the "record leaves no doubt that TEFRA required numerous changes in existing state administrative procedures . . . [T]hese changes consumed personnel time and required the

expenditure of computer and financial resources." (*Id.* at 40).

3. Transaction Costs

In order to determine the transaction costs associated with the issuance of registered bonds, both parties engaged the Government Finance Research Center to conduct a joint study of registration transaction costs. (Report at 40). The study found that the ongoing administration costs — such as the fees paid by issuers for the payment of interest coupons, and retirement of principal — were higher for registered than bearer bonds for the smaller issues, that is, under $10 million. (*Id.* at 41). Seventy-six percent of municipal bond issues are of $10 million or less. (Stip., Para. 13). In addition, certain fixed costs, such as the high minimum annual fee charged by transfer agents, had a greater financial impact on those smaller issuers. (Report at 43).

4. Interest Rate Differential

The interest rate differential — a higher rate of interest demanded by purchasers of registered bonds — proved to be the most difficult cost for either plaintiffs or defendant to assess.* In its original complaint South Carolina asserted that issuance in registered form would impose a substantial interest penalty. (Brief of Plaintiff at 22). Although the

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* Because the bond market may fluctuate as much as 10-20 basis points daily, it is very difficult to isolate a differential of 5-15 basis points between points in bearer and registered form. (PX 200 at 4). In order to determine, without an econometric model, that a differential existed, a bond trader would have to see two bonds that were identical in every way, except for their form, bearer or registered, trade at the exact same time. This will never occur often enough to assess the differential accurately.

penalty asserted would be enormous in real dollars, the differential — a matter of several basis points — was small enough relative to bond market fluctuations to be very difficult to measure. The Secretary devoted substantial resources to developing a primary market model that would accurately determine the differential. (*Id.* at 45). But the study had fundamental flaws and the Special Master concluded that it was unreliable. (*Id.* at 76-77).

There were three ways to go about measuring the differential: rely on testimony of market witnesses, try to measure the differential in the primary (original issuance) bond market, or try to measure the differential in the secondary (trading of already-issued bonds) market. Plaintiffs eschewed the first two methods as unreliable. (*Id.* at 56). The first method was unreliable because a differential of several basis points simply could not be unobserved in a fast-moving market even by an experienced observer — instead, an econometric study was required. (PX 200). And, it is unnecessary to dwell at length on the difficulty with a primary market study — the Master was convinced it was wholly unreliable. A primary market study requires a comparison of matched pairs of registered and bearer bonds in the primary market after TEFRA. But because there were no bearer municipal bonds issued after TEFRA, it was difficult "to develop surrogates for a direct comparison." (*Id.* at 55). The Master found that this was "a fundamental methodological difficulty with the Secretary's primary market study." (*Id.* at 75).

Both the plaintiffs and defendant presented secondary market studies performed by economists and statisticians in the field to try to show that the enactment of TEFRA had an effect on the interest rates of municipal bonds. The plaintiffs' study indicated a 5-15 basis point differential, but the Master found the study unreliable. (*Id.* at 62, 76). Initially, the Secretary's study did not show a differential; but in the course

of the trial testimony, plaintiffs' experts demonstrated that a crucial data error in the Secretary's secondary market study had skewed the sample away from showing a differential.* Once the error had been corrected, the Secretary's secondary market study produced results that supported the claim of the plaintiffs that an interest rate differential does in fact exist. (*Id.* at 70; Tr. 1663-65). Although plaintiffs found the data error, they did not — nor could they — fault the comprehensiveness or methodology of the Secretary's model. It was exhaustive and expensive. But once plaintiffs located the error with the result of changing the conclusions, the Secretary sought to abandon his study. (Report at 70).

The Secretary's representatives, on numerous occasions, had expressed confidence in the thoroughness of the study even though their expectation of its results proved wrong after the data error was rectified: "[I]t is a very comprehensive study, and [it] will conclude that unequivocally there is no indication that . . . there's a penalty. . . . Registration does not create an interest penalty for the issuers." (Opening Statement by Donald J. Gavin, Trial Counsel for the Secretary, Tr. 105-106). During his deposition, defendant's expert, Donald Puglisi, when asked about the reliability of the data,

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* The Secretary's secondary market study compared sets of matched registered and bearer bonds in that market to measure the differential. But the Secretary's study erroneously included one large matched set in which a registered bond with bond insurance was paired with a bearer bond without bond insurance. (Tr. 1660-62). Obviously an insured bond sells at a premium to an uninsured one, so the erroneous inclusion of this set skewed the study results. When the set was removed, the Secretary's study showed an eight basis point differential, with a very high degree of statistical significance.

stated that he was "as sure as [he] can be" that it was reliable and that he had used the "best sources available." (Puglisi deposition at 38).

Contrary to the finding of the Special Master, the Secretary did not abandon his study because it was unreliable and its conclusions untenable, but simply because it no longer supported his claims. (Report at 70). Plaintiffs maintain the Master's finding is in error and that plaintiffs proved that the Secretary's study substantiated plaintiffs' claim that a 5-15 basis point differential existed, which would result in an annual cost to state and local governments of $100 million per basis point for each year TEFRA was in force. (PX 200).

5. The Diminution of Sovereignty

The sovereign power to impose taxes and to make decisions is central to the separate and independent existence guaranteed to the several states by the Constitution. Raising funds in public markets has been, for more than a century, a fundamental part of the exercise of that power that lies at the heart of a state's autonomy. In addition to noting the four intrusions, described above, plaintiffs argued that the commandeering of state legislative processes diminished their sovereignty. *See Coyle* v. *Smith*, 221 U.S. 559 (1911). The essence of state sovereignty is the power of the States to make basic organizational and operational decisions without federal directives. Requiring debt to be issued in registered form has limited the decision-making function of the state and local governments because it dictates to the governments charged with the authority to issue debt and the responsibility to repay it the policy decision of the form and means of issuance of that debt. Thus, compliance with Section 310(b)(1) diverts state governments from other critical issues, diminishing their separate and independent existence.

THE SECRETARY'S CASE: MARKET AND TAX BENEFITS

With the exception of the interest rate differential, the Secretary accepted plaintiffs' evidence as to the intrusions set out above, disputing only their weight and constitutional significance. In order to mitigate the weight of the intrusions established by plaintiffs, the Secretary premised his entire case upon proving the benefits of registration to the bond market and the national fisc.

1. Market Benefits

The Secretary sought to prove that issuers would benefit from market efficiencies inherent in the registration process. (Report at 79). Plaintiffs consistently maintained this evidence was irrelevant, both because Congress had not justified the statute on these terms, and because there was no evidence that such efficiencies inured to the benefit of issuers. The Special Master agreed, finding that "although in a perfect market one would expect that market efficiencies would redound to the benefit of issuers, there is no direct evidence of this in the record." (*Id.* at 80). In response to the Secretary's one assertion of a direct benefit — that underwriting spreads had been reduced in response to registration — the Master explicitly found "it seems unlikely that registration would account for the major part of these issuer savings." (*Id.*). In fact, there is no evidence that registration accounted for the issuers' savings. The Secretary evidently does not challenge this finding. (Letter from Charles Fried, Solicitor General of the United States to Joseph Spaniol, Jr., Clerk of the Supreme Court (January 28, 1987) (notifying the Court that the Secretary would not except to any of the Master's findings)).

2. Tax Benefits

The objectives Congress sought to accomplish by its enactment of Section 310(b)(1) were set out in the Senate Report. First, Congress sought to establish a "fair and efficient system of information reporting and withholding . . . [of] interest bearing obligations." The Committee felt that registration would produce useful information while preserving the liquidity of the obligations. Second, Congress believed that registration would hamper the ability of recalcitrant taxpayers to avoid income, estate and gift taxes by the use of bearer bonds. Finally, Congress expressed a belief that registration of bonds would reduce the volume of convenient cash substitutes available for use in illegal activities. S. Rep. No. 494, 97th Cong., 2d Sess., 242 (1982).

These three goals, as set out by the Committee in its report, were adapted virtually without change from the testimony of Assistant Secretary for Tax Policy, John Chapoton before the Senate Finance Committee. (Tr. 935-38). Mr. Chapoton admitted at trial that neither he nor his staff at the Department of Treasury had conducted any studies or analyses that would support his testimony. Despite this lack of analytic support, Congress enacted Section 310(b)(1) based on the benefits recited by Mr. Chapoton. At trial, the NGA vigorously contested whether the statute addresses the problems that Congress perceived. The Special Master has admitted that the arguments presented by plaintiffs "do have some force." (Report at 85). The NGA fully supports Congress' objective to discourage tax evasion but continues to question whether the Section contributes to that crucial effort.

In reverse order, Congress' third rationale — illegal money laundering — was abandoned by the Secretary at the

outset of the litigation. In response to discovery requests for information that municipal bearer bonds were used to launder funds, the Secretary chose not to defend the statute on this ground. (Letter from Glenn L. Archer, Jr., Assistant Attorney General, Tax Division to Barry Friedman (October 25, 1985) (noting that the "extent and nature of money laundering is not an issue in this case")). The Special Master also found no evidence to suggest that bearer bonds may have been used as a cash substitute for illegal activities. (Report at 84).

Chapoton's main rationale, which was echoed in the Senate Report, concerns the ability of noncompliant taxpayers to avoid taxation by use of bearer bonds. There are three kinds of taxes which Congress could have had in mind: federal income tax, capital gains tax and estate and gift tax. Because interest on municipal bonds is not taxable under federal law, the interest income tax evasion argument has no force. With regard to concealment of other kinds of taxes, the Special Master correctly found that there is no evidence "quantifying the estate and gift tax evasion [or] capital gains tax evasion." (*Id.* at 84).

Even assuming the evasion Congress suspected, registration is of little enforcement value. The primary means of addressing alleged bearer bond abuse was increased information reporting. This was Congress' first goal. With regard to the information reporting goal, however, even the Special Master conceded that there are "imperfections in the regulatory scheme [of Section 310(b)(1)]." (*Id.* at 88). As a result, the Special Master rightly concluded that "there are limitations to the utility of the registration requirement as an aid to

tax enforcement." (*Id.* at 88). Brokers are required to file information regarding the transfer of bonds and were required to do so even prior to the passage of TEFRA. But registered bonds, like bearer bonds, can be transferred without a broker. (Tr. 939-940). In other words, persons trading bonds can still evade reporting requirements. Moreover, it does not help to add a transfer agent to the system, as registration does, for transfer agents have no reporting obligations to the IRS.*

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* The Special Master erred in finding that "IRS and treasury officials have the authority under existing statutes to require information reporting by transfer agents when and if it is deemed necessary." (Report at 83). Although brokers report trades of both bearer and registered bonds to the Internal Revenue Service, there is no legislative authority to require transfer agents charged with transferring registered bonds to report transfers.

Section 6045(a) of the Internal Revenue Code provides that only a person "doing business as a broker" must, when required by regulations, make an information return in accordance with regulations. Therefore, the Internal Revenue Service may not require such information reporting by persons other than brokers. The term "broker" is defined in Section 6045(c) of the Code as a "dealer, barter exchange or any other person who (for a consideration) regularly acts as a middleman with respect to property or services." Section 1.6049-4(f)(4) of the regulations defines "middleman" as any person who "acts in a capacity as intermediary between a payor and a payee." A transfer agent who merely records the names of the beneficial owners of the bonds therefore does not act as middleman with respect to bond sale payments.

Logic indicates that Congress could not have intended to confer on the Internal Revenue Service power to require the filing of returns setting forth the proceeds of sales when those filing would have no knowledge of such proceeds. A transfer agent merely records the fact of a record transfer, but has no actual knowledge or reason to have knowledge of the nature of the transaction that caused the transfer, *i.e.*, whether it was a sale involving gross proceeds or whether it was a gift or transfer at death. Further, even if a transfer agent had reason to believe that a transfer involved a sale, the transfer agent would have no knowledge as to the gross proceeds of the sale. Accordingly, transfer agents would be unable

(See PX 120, attached).

As the Master found, the only real value to registration is that there is somewhat more of a "paper trail" in place for use by IRS agents tracing tax fraud. But this paper trail is of very limited utility. First, it requires locating specific bonds that the IRS suspects were used for evasion. But even when bearer bonds actually were found by IRS agents, they generally could determine who possessed them. Second, because registered bonds can be held in nominee name, even the registration paper trail may not ultimately lead IRS agents to the bonds' owner.

The Special Master agreed with the plaintiffs that the registration requirement imposed certain burdens on the states. He also noted the fragility of the benefits to which the Secretary pointed. Because the Master examined the weight not the nature of the intrusions imposed by Section 310(1)(b), he found that those intrusions were not enough to justify striking the Section in light of the tax benefits asserted by the Secretary and Congress' intent in passing the statute. It is to the crucial constitutional test of the nature of the impositions created by this statute that we now turn.

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to comply with any information reporting requirements that the Internal Revenue Service might seek to impose upon them. There is, therefore, no basis for the Internal Revenue Service to believe that it has the power to extend its regulations in such a manner.

SUMMARY OF ARGUMENT

Section 310(b)(1) effectively requires the states and local governments to use their legislative and administrative power to satisfy a federal directive; by so doing this statute interferes with the States' separate and independent existence in violation of the principles of federalism expressed by the Tenth Amendment. Those principles impose certain limits on the reach of Congress' power to regulate the states. Although the contours of those limits have not been free from doubt for this Court, it has never been questioned that their foundation may be found in the very structure of the Constitution which establishes a national government but contemplates the continued and autonomous existence of the States.

Most recently in *Garcia v. San Antonio Transit Auth.*, 469 U.S. 528 (1985), this Court observed that while the national political process offers the states their first defense against improper federal intrusion, there are also "affirmative limits" on Congress' power to regulate them. These limits are described by the precedent that the *Garcia* Court both cited, *Coyle v. Smith*, 221 U.S. 559 (1911) and left untouched, *FERC v. Mississippi*, 456 U.S. 742 (1982). In *Coyle*, cited by the *Garcia* Court in support of its notion of affirmative limits, this Court struck down a federal statute that dictated to a state where it should place its state capital. In *FERC*, while this Court upheld a statute that asked states to consider the implementation of federal regulations, it observed that the statute was valid only because the state deliberative processes were not co-opted by the federal command.

The line that *Coyle* and *FERC* drew separated those actions that Congress may constitutionally require the States to take from those it may not. Although the evil warned

against in *FERC* was the actual commandeering of state processes, *Coyle* made clear that the symbolic occupation by the federal government of the statehouse was also invalid.

When the *Garcia* Court proffered to the States the recourse of the national political process as their defense against illegitimate federal intrusion, it contemplated the continued and vigorous ability of the States to assert their — or rather their citizens' — needs. By picking up the baton passed by *FERC* and *Coyle*, the *Garcia* Court implied that the States' ability to function in the federal system as separate and independent — to operate for the benefit of their citizens in the political process — would be threatened as much by a symbolic as an actual kidnapping of state government by Congress.

Section 310(b)(1) poses just such a threat because by its very nature it requires the states to subordinate their own agendas to that of the federal government. While Congress may achieve its ends by direct action — as it could have easily done in this case — it may not reach its goal by using state machinery when to do so would crucially divert the States' attention from the needs of their citizens. This is because our federal system presumes that its citizens have the right to the attention of both its sovereigns and, in particular, the attention of the state government to their needs. This is not to say that in times of dire national emergency the federal government may not, for a brief time, press all the nation's resources, including that of the state, to its service. This, however, is not such a case. Rather the demands made here by the federal government transgress those affirmative limits so carefully plotted by *Coyle*, *FERC* and *Garcia*.

ARGUMENT

I.

SECTION 310(b)(1) IS NOT A TAX, BUT IS A REGULATION OF THE STATES THAT REQUIRES THEM TO REGISTER MUNICIPAL OBLIGATIONS

The constitutional question properly presented by this case is whether Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") is consistent with the principles of federalism expressed in the Tenth Amendment.* This legislation is constitutionally suspect because it in effect required the States to pass laws and devote substantial administrative resources solely to satisfy a federal directive, a role inconsistent with their separate and independent existence in the federal system.

At the outset, plaintiffs advanced two arguments challenging the constitutionality of Section 310(b)(1). First, plaintiffs argued that requiring the States to issue debt in registered form, with its attendant usurpation of state political processes, violated principles of federalism expressed by the Tenth Amendment. In addition, plaintiffs contended that under the intergovernmental tax immunity doctrine, Congress was without constitutional authority to eliminate the tax

* In this brief we use "Tenth Amendment" and "principles of federalism" interchangeably because the Tenth Amendment is an expression of the principles of federalism implicit throughout the Constitution. The Tenth Amendment "expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system." *Fry v. United States*, 421 U.S. 542, 547 n.7 (1975).

exemption on municipal debt. This Court appointed a Master to develop and find facts on both issues.

It is now clear, in the aftermath of extensive fact-finding proceedings, that it is not necessary for this Court to address the intergovernmental tax immunity issue. That is because Section 310(b)(1) is not a tax, but is a regulation in aid of Congress' taxing power. *See, e.g., M'Culloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316 (1819). If any municipal authority had issued bonds in bearer form subsequent to the effective date of Section 310(b)(1) the tax exemption on those bonds would be lost and a tax immunity issue would be presented. But the Master found that, as expected, Section 310(b)(1) effectively mandated state and local governments to register their bonds. After the effective date no state failed to comply and none incurred the tax penalty. Thus, Section 310(b)(1) must be examined, and reversed or upheld, as what it in fact is: not a tax but a regulation in aid of Congress' taxing power.*

Facts found before the Master amply support the conclusion that Section 310(b)(1) is a regulation, not a tax. The Master determined that he need not decide the question of whether Congress could eliminate the tax exemption, because Congress had not done so. Rather, Congress clearly anticipated that all government entities would register rather than forfeit the exemption. At the outset of the litigation, the

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* Congress expressed no intention to pass this law in order to increase revenue, and no revenue has been raised as a result of its passage. Without either the intent or effect of raising revenue this Section lacks the single most important indicia of a tax. *See United States* v. *Kahriger*. 345 U.S. 22, 28 (1953); *see also, South Carolina* v. *Regan*, 465 U.S. 367, 384 (1984) (Blackmun, J., concurring) ("evident" that purpose of Section 310(b)(1) was not "to produce revenue").

parties stipulated to the fact that the tax penalty associated with registration was so great that all state and municipal governments would register. (Stip., Para. 6). And the Master found that all have done so: the Master concluded, at the very beginning of his report, that Section 310(b)(1) "in effect *requires* the registration of all municipal bonds." (Report at 2) (emphasis supplied).*

* The Special Master's report was somewhat inconsistent in its application of this finding. In response to the Tenth Amendment argument, the Master determined that the statute was constitutional, in part because Congress did not require States to use governmental machinery to a federal end, but offered the States the choice of registering to retain the tax exemption or not registering and forfeiting the exemption. In response to the tax immunity argument, the Master determined that he need not decide whether Congress could eliminate the exemption because Congress had not done so, clearly anticipating that all government entities would register rather than forfeit the exemption. However, the statute either required registration or it provided a choice: both cannot be true.

In light of the actual operation of the statute, under which every State did switch to registered bonds — a result that the Congress anticipated and the parties stipulated to — it is evident that this inconsistency can only be resolved by recognizing that the section did *require* the States to register their obligations. The Master found that to be a fact. (Report at 2).

II.

THE PRINCIPLES OF FEDERALISM PROHIBIT CONGRESS FROM COMMANDEERING STATE LEGISLATIVE PROCESSES TO ACCOMPLISH A FEDERAL REGULATORY END THAT IS WITHIN CONGRESS' MEANS TO ACCOMPLISH

A. The Constitutional Scheme Limits Congress' Power To Regulate The States

Plaintiffs maintain that the regulatory impact of Section 310(b)(1) is invalid not because it is beyond the scope of Congress' delegated powers, but because it transgresses limits that may be found in the very structure of the constitutional scheme, a structure which established a national government, but which also contemplates the continued, separate and independent existence of the States. The structure of the Constitution presupposes the independent existence of state governments. The Tenth Amendment makes this much clear, providing that the "powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. Const. amend. X. In glossing that amendment, this Court has observed that the "Amendment expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system." *Fry* v. *United States*, 421 U.S. 542, 547 n.7 (1975).

Congressional legislation that treats the States inconsistently with their independent status is not invalid because it crosses some explicit line, but because it is contrary to the assumption underlying the Framers' vision of the Constitution as a whole. *Texas* v. *White*, 74 U.S. (7 Wall.) 700, 725 (1869) ("the preservation of the States, and the maintenance

of their governments, are as much within the design and care of the Constitution as the preservation of the Union and the maintenance of the National Government"). Congress has broad power to raise taxes for the general welfare and generally may enact any regulation necessary and proper to effectuate that power. In this case, however, the object of congressional regulation is the legislative, administrative and political processes of state government. Accordingly, that regulation must be tested against the principles of constitutional federalism.

Determining exactly what kind of legislation treats States in a manner that is inconsistent with the federal scheme has been an inquiry not free from trouble for this Court. *See EEOC* v. *Wyoming*, 460 U.S. 226 (1983); *United Transportation Union* v. *Long Island Railroad Co.*, 455 U.S. 678 (1982); *Hodel* v. *Virginia Surface Mining & Reclamation Ass'n*, 452 U.S. 264 (1981); *National League of Cities* v. *Usery*, 426 U.S. 833 (1976). Most recently in *Garcia* v. *San Antonio Metropolitan Auth.*, 469 U.S. 528 (1985), this Court suggested a new approach to defining the limits of congressional authority to regulate the states.

In *Garcia*, this Court re-evaluated the framework it had established ten years before for determining the constitutionality of direct federal regulation of the states. Under the rule established by that earlier decision, *National League of Cities* v. *Usery*, 426 U.S. 833 (1976) "areas of traditional governmental functions" were considered immune from federal regulation. *Id.* at 852. Over time it became clear that the test could not be applied with any consistency of result because of the difficulty in distinguishing a traditional governmental function from a nontraditional one.

Recognizing the futility of attempting to carve out specific areas of state authority that would be held relatively free from federal regulation, the *Garcia* court chose to

abandon this approach, and relied instead on the "principal means chosen by the Framers to ensure the role of the states in our federal system," that is, "the structure of the Federal Government itself." *Garcia*, 469 U.S. at 550. Instead of totting up governmental functions as pluses or minuses in some ultimate constitutional ledger, this Court determined to rely upon the self-regulating role of politics to keep our dual system of sovereignty faithful to the Framers' conception of federalism; in this scheme it is the political process, rather than the Supreme Court, that provides the primary protection of the States' autonomy.

Despite its primary reliance on the political process, the *Garcia* Court did not hold, and could not have held consistent with 200 years of constitutional history, that Congress was without bounds in regulating the States. Rather, the *Garcia* majority explicitly recognized the "special and specific position" of the States in our federal union, and acknowledged that there were "affirmative limits" upon Congress' power to depose the States from their special position. *Garcia*, 469 U.S. at 556. For the principle that "affirmative limits" exist the Court cited *Coyle* v. *Smith*, 221 U.S. 559 (1911). *Coyle*, in turn, had affirmed that "the Constitution, in all of its provisions looks to an indestructible Union, composed of indestructible States," *id.* at 579 (quoting *Texas* v. *White*, 74 U.S. (7 Wall.) 700, 725 (1869)) "having its own government, and endowed with all the functions essential to separate and independent existence." *Id.* at 580 (quoting *Lane County* v. *Oregon*, 74 U.S. (7 Wall.) 71, 76 (1869). And, it is this concept that the Court itself looked to in *Fry* v. *United States*, 421 U.S. 542 (1975) in an opinion joined by four Justices of the *Garcia* majority then on the Court when it stated that the

Tenth Amendment

> expressly declares the constitutional policy that Congress may not exercise power in a fashion that impairs the States' integrity or their ability to function effectively in a federal system.

Id. at 547 n. 7.

Moreover, *Garcia* did not suggest that the Court would turn a deaf ear to claims by the States that congressional legislation seriously impaired their "ability to function effectively" in the federal system, *Fry*, 421 U.S. at 547 n.7, abdicating all responsibility for regulating Congressional incursions into areas of state power. Although the Secretary has taken that position in this litigation, to follow him would be to overrule *sub silentio* this Court's oldest and soundest precedent. Time and time again this Court has asserted and jealously guarded its role as the final arbiter of what the Constitution requires and as the final umpire of disputed areas of authority between the states and the national government. *See, e.g., Marbury* v. *Madison*, 5 U.S. (1 Cranch) 137 (1803); *M'Culloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316 (1819); *Fry*, 421 U.S. 542; *Maryland* v. *Wirtz*, 392 U.S. 183 (1968).* *Garcia* is not inconsistent with these core principles: the

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* *See generally*, Van Alstyne, *The Second Death of Federalism*, 83 Mich. L. Rev. 1709 (1985) (discussing historical support for Supreme Court's role as arbiter and noting that the country never would have ratified a constitution that explicitly excluded the Supreme Court and left to the national Congress the resolution of questions concerning State sovereignty). It is consistent with this "important duty" of the Supreme Court that the Court's original jurisdiction specifically applies to suits by the States against the national government. *See South Carolina* v. *Regan*, 465 U.S. 367, 384 (O'Connor, J., concurring) (original jurisdiction provides States acceptable alternative to diplomacy and war for settling disputes).

Garcia Court stated only that in the factual setting of *National League of Cities* and *Garcia* the political process had performed as intended, and therefore "[t]hese cases do not require us to identify or define what affirmative limits the constitutional structure might impose on federal action affecting the States." *Garcia*, 469 U.S. at 556.

B. Congress May Not Commandeer State Legislative And Administrative Processes, For This Threatens The Separate And Independent Existence of the States

The *Garcia* Court made it clear that although the Court expects the national political process generally to protect state autonomy, there are affirmative limits upon Congress' power to regulate the States directly. While this Court did not explicitly describe those limits, the framework it offered and the one hundred years of precedent it left untouched indicate that this Court will scrutinize carefully the intrusiveness of Congressional regulation of the States to insure that the regulation does not threaten the States' separate and independent existence.

As developed below, it is plaintiffs' position that Congressional legislation threatens the separate and independent existence of the states when it co-opts state governmental machinery to federal ends, diverting state governments from their own pressing agendas. *See FERC* v. *Mississippi*, 456 U.S. 742 (1982); *Coyle* v. *Smith*, 221 U.S. 559 (1911); *See infra* at 30-38. Section 310(b)(1) had the effect of usurping state political and deliberative processes, requiring the states to pass laws and devote significant administrative resources to implementing the federal plan. Plaintiffs maintain it is precisely this kind of federal interference in the autonomous workings of state government — the co-option of state government machinery to federal ends — that threatens the "separate and independent existence" of the states,

hampering their ability to function in the national political process, and transgressing the "affirmative limits" acknowledged by the *Garcia* Court. That is not to say that in a case of national emergency Congress could not request temporary assistance from state governments. *See FERC*, 456 U.S. at 745. *See infra* at 42-44. But in this case Congress had adequate means in its own governmental arsenal to combat the tax evasion problems it perceived.

In order to understand the malady of the federal intrusion in this case, it is necessary to return to the fundamental constitutional point that whatever "rights" a state has derive from its role as protector of and proxy for the individual rights of its citizens. The Tenth Amendment, after all, states that all powers not expressly delegated to the federal government are "reserved to the States respectively, or to the people." U.S. Const. amend. X. And in *Coyle* v. *Smith*, 221 U.S. 559 (1911) — the *Garcia* Court's citation for the "affirmative limits" proposition — the Court also made clear that the sovereignty of the citizenry was of paramount concern, stating "*[t]he people of each state* compose a state having its own government, and endowed with all the functions essential to separate and independent existence." *Id.* at 580 (quoting *Lane County* v. *Oregon*, 74 U.S. (7 Wall) 71, 76 (1869)) (emphasis added).

By ratifying the Constitution, the people created a federal government, but they also sought to guarantee the separate and independent existence of the States, free to pursue independent state agendas. *The Federalist* No. 39 at 260 (Madison) (E. Bourne, ed. 1937); *Erie R.R. Co.* v. *Tompkins*, 304 U.S. 64, 78-79 (1938); *Texas* v. *White*, 74 U.S. (7 Wall.) 700, 725 (1869). Under the constitutional plan envisioned by the Framers, and ratified by the people of the States, the federal government possesses certain delegated powers, while everything not delegated is reserved to the States. U.S. Const. amend. X. Under that plan citizens have an

expectation and indeed a right to a state government unhampered by federal demands and free to respond to the citizens' needs. It is the importance of having the attention of both sovereigns, if focused in different ways, that is the special mark of American federalism. Action on the part of the Congress that removes state political processes from direct control of state citizens, diverting state government to federal ends, accordingly is invalid under *Garcia*.

The two hundred years since the ratification of the Constitution have seen an expansive interpretation of the powers delegated to the national government. *Wickard* v. *Filburn*, 317 U.S. 111 (1942). This expansion has been an appropriate response to an equally expansive concept of the fifty states as one nation. Advances in technology, communication and transportation all have served to draw together the people of the fifty states, presenting problems of uniquely national scope that require national solution. Despite this expansion of federal authority, however, federal legislation, enacted in response to pressing national needs, or at the behest of special interest groups, tends to be "generally interstitial in its nature." Hart and Wechsler, *The Federal Courts and the Federal System*, 470 (2d ed. 1973).

> Federal legislation, on the whole, has been conceived and drafted on an *ad hoc* basis to accomplish limited objectives. It builds upon legal relationships established by the states, altering or supplanting them only so far as necessary for the special purpose. Congress acts, in short, against the background of the total *corpus juris* of the states in much the way that a state legislature acts against the background of the common law, assumed to govern unless changed by legislation.

Id at 470-71.

Thus, the people of the States continue to look to state government to fulfill basic and changing needs. State government is the ultimate provider of fundamental needs and services. *See, e.g.*, Michelman, *States' Rights and States' Roles: Permutations of "Sovereignty" in National League of Cities* v. *Usery*, 86 Yale L.J. 1165 (1977); Tribe, *Unravelling National League of Cities: The New Federalism and Affirmative Rights to Essential Government Services*, 90 Harv. L. Rev. 1065 (1977); Kaden, *Politics, Money, and State Sovereignty: The Judicial Role*, 79 Colum. L. Rev. 847 (1979). When the people's needs are basic — education, police, transportation — it is to state government that the people look first. When a state "speaks" in a national forum it speaks for its citizens and expresses their concerns. Citizens look to the States as their primary provider, as the first level of government; the States must be able to respond to and shape those demands if they are to establish their sovereignty. States provide the first, and sometimes the only, response to "the changing needs of their citizenry." *Garcia*, 469 U.S. at 546; *see also* Governor Thompson's testimony (Tr. 387) (states "have been on the cutting edge of government reform and on the cutting edge of the utility of government in making a better life for our people").

In order to meet these needs, state governments must be able to develop and further their own agendas free from federal intrusion. Agenda-setting, the determination how to allocate scarce legislative and administrative resources lies at the heart of what it means to be a separate and independent unit of government. The "affirmative limits" acknowledged in *Garcia* are violated when congressional legislation diverts state government from state agendas. When the federal government moves into a new area, it may preempt state efforts and deal with the problem in a national manner. *Pacific Gas & Elec. Co.* v. *State Energy Resources Conservation and Dev. Comm'n*, 461 U.S. 190 (1983); *Hines* v.

Davidowitz, 312 U.S. 52 (1941). But, the federal government must pursue its agenda without impeding state efforts to deal with the multitude of problems that they, like the federal government, face. The *Garcia* majority recognized precisely this point, stating:

> The essence of our federal system is that within the realm of authority left open to them under the Constitution, the States must be equally free to engage in any activity that their citizens choose for the common weal, no matter how unorthodox or unnecessary anyone else — including the judiciary — deems state involvement to be.

Garcia, 469 U.S. at 546; *see also Helvering* v. *Gerhardt*, 304 U.S. 405, 427 (1938) (Black, J., concurring) ("the genius of our government provides that, within the sphere of constitutional action, the people — acting not through the courts but through their elected legislative representatives — have the power to determine as conditions demand, what services and functions the public welfare requires").

The invalidity of the federal intrusion in this case rests on the fact that Section 310(b)(1) unnecessarily co-opts state legislative and political processes to a federal end. It commandeers the state's political processes and puts it to the task of addressing, in a specific and short time-frame, the agenda determined by the federal government. When the federal government chooses to address a new regulatory program and then compels state governments to implement that program, the states not only lose control over a matter formerly within state purview, but also must abandon other vital state concerns to carry out the federal command. The former is the price of our federal system; the latter is forbidden, for it deprives the citizens of the several states of a separate and independent government addressed to separate and independent problems. *See Texas* v. *White*, 74 U.S. (7 Wall.) 700,

725 (1869); *Lane County* v. *Oregon*, 74 U.S. (7 Wall.) 71 (1869); *Coyle* v. *Smith*, 221 U.S. 559 (1911); *Fry* v. *United States*, 421 U.S. 542 (1975). Any other interpretation of "separate and independent" reduces the state governments to administrative units in the federal hierarchy.

FERC v. *Mississippi*, 456 U.S. 742 (1982) indicates that federal co-option of state governmental processes violates the affirmative limits referred to in *Garcia*. Although the *Garcia* court addressed, and explicitly rejected, the mode of analysis of *National League of Cities* and its progeny, the *Garcia* Court did not discuss *FERC*, recognizing (as did the *FERC* Court) that the intrusiveness of federal regulation at issue in *FERC* was different in kind from that in the *National League of Cities* cases:

> This case obviously is related to *National League of Cities* v. *Usery*, 426 U.S. 833 (1976), insofar as both concern principles of state sovereignty. But there is a significant difference as well. *National League of Cities*, like *Fry* v. *United States*, 421 U.S. 542 (1975), presented a problem the Court often confronts: the extent to which state sovereignty shields the States from generally applicable federal regulations. In PURPA [the statute at issue in FERC], *in contrast, the Federal Government attempts to use state regulatory machinery to advance federal goals. To an extent, this presents an issue of first impression.*

FERC, 456 U.S. at 758-59 (emphasis supplied).

FERC involved a challenge to Titles I and III of the Public Utility Regulatory Policies Act of 1978 ("PURPA") that directed state utility regulatory commissions and nonregulated utilities to "consider" the adoption and implementation of specific "rate design" and regulatory standards; it also required state commissions to follow certain notice and comment procedures when acting on proposed federal standards.

Id. at 746, 748.

The *FERC* Court observed that differences between *FERC* and the *National League of Cities* cases presented a "troublesome" question: although the federal government has "some power" to enlist state processes to federal ends, it had to be careful that the power not be used to displace state government. *Id.* at 761. The Court never had "sanctioned explicitly a federal command to the States to promulgate and enforce laws and regulations," *id.* at 762, precisely because it is "having the power to make decisions and to set policy [that] gives the State its sovereign nature." *Id.* at 761.

It is the *FERC* decision, therefore, that forges the link between the *Garcia* Court's insistence that affirmative limits exist and the unquestioned constitutional command that states retain their separate and independent existence. The separate and independent existence of the States means that states must be free to pursue the regulatory agenda of their citizenry. And, it is in a state's deliberative body that the people speak directly to the government to express their needs. It is a state's administrative processes that carry out the will of the people expressed in state legislation. In the state political arenas — legislative and administrative — the States form and carry out the agenda that will make them effective advocates for their own existence, that is, their role as their citizens' providers.

Depriving the States of the ability to control their own deliberative processes limits their effectiveness in the national political process. This explains the *Garcia* Court's reliance on *Coyle* for the "affirmative limits" proposition. The *Garcia* Court indicated that it is this federal interference in state deliberative processes that threatens the separate and independent existence of the States. In *Coyle*, the Court struck down a federal statute that changed the location of a state capital. It cannot be seriously contended that loss of the

power to determine the seat of government would, in one fell swoop, obliterate states as we know them. Whether the Oklahoma state legislature passes its laws in Tulsa rather than Oklahoma City would not affect their content.

What this Court recognized in *Coyle* was that although the placement of the state capital may have little impact on the day-to-day functioning of state government, it would have a very real effect on a state's citizens' perception of the autonomy — and therefore efficacy — of its state government. The state's effectiveness relies upon the support and belief of its citizens. This support is undermined when the citizens believe that the state does not even have the ability to choose its own seat of government. A state bereft of the autonomy to make such internal decisions is unlikely to have any serious credibility in the national political process.*

Garcia's affirmative limit, therefore, is that Congress may not unnecessarily co-opt state political, deliberative and administrative processes to federal ends. If Congress perceives a national need, Congress may address it, even if it means depriving state government of authority over a formerly "traditional" state area. *See, e.g., National League of Cities* v. *Usery*, 426 U.S. 833 (1976). But, Congress must address the concern on its own, leaving the state governments free to pursue the remaining needs of their citizenry. *See Garcia*, 469 U.S. at 546.

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* Indeed, the central concern in *Coyle* was that the federal government treat every state with equal dignity. It was only when the states stood on this equal footing as to their sovereign functions and attributes, that they could fulfill their role as "indestructible" states without which the Union could not exist. Just as equal dignity is essential, one state to another, equal dignity is important between the States and the federal government if the States are to retain a vital voice in the national political process.

C. Section 310(b)(1) Co-opts State Legislative Machinery And Therefore Is Unconstitutional

Measured by the *FERC* decision and the principles underlying it, Section 310(b)(1) must fall because the federal intrusion is precisely of the type that threatens the separate and independent existence of the States. Section 310(b)(1) effectively mandates the States to abandon other priorities, to enact laws and to divert other significant financial and administrative resources simply to accomplish federal ends well within the independent power of the federal Congress to achieve. *See infra* at 42. The fact that Section 310(b)(1) effectively requires state legislation is particularly suspect for the Supreme Court "never has sanctioned explicitly a federal command to the States to promulgate and enforce laws." *FERC*, 456 U.S. at 761-62.

More than in *FERC* or *Coyle*, the co-option of state democratic processes by Section 310(b)(1) transgresses the affirmative limits on Congress' power to regulate the States. For more than half of the states, compliance with TEFRA demanded either a change in state laws or a very imaginative interpretation of the state laws. *Report of the Conference on Registered Municipal Securities* at 9. Enormous expenditures of administrative resources were required. See *infra* at . A full plate of state and local issues was reorganized to make room for federal priorities.

In order to comply with TEFRA, the States had to repeal old laws and pass new ones. The Special Master observed that "the time and money expended to comply with TEFRA, both at the legislative and administrative levels, was not insignificant." (Report at 36). The commandeering of state legislative processes is evident in the proof that NGA presented at trial. In New Jersey, for example, forty-seven different statutes had to be amended in order to comply with TEFRA. In Kansas, eighty-six statutes had to be amended

and three repealed; and in Michigan, a similar diversion of state resources was required to comply with the registration requirement. (Report at 38). This experience, typical of the States, forced state officials to turn the time and resources of the state from other functions and priorities of state government, including pressing executive and legislative business.

These are precisely the burdens Congress may not impose consistent with the Tenth Amendment. This diversion of state attention away from its sovereign processes is the line that *FERC* made clear the federal government could not cross. By co-opting state processes to federal ends, Congress deprives the States of the very weapon that *Garcia* proffered in order for them to maintain their role in the federal system.

In *FERC*, this Court ultimately approved the statute because it merely asked state administrative bodies to "consider" the federal proposals, but did not require the promulgation of particular regulations.* The mere consideration of federal proposals was deemed acceptable as part of a program of cooperative federalism. Quoting *Hodel* v. *Virginia Surface Mining & Reclamation Ass'n*, 452 U.S. 264, 289 (1981), the Court stated that:

> [t]he most that can be said is that the . . . Act establishes a program of cooperative federalism that allows the States, within limits established by federal minimum standards, to enact and administer their own regulatory programs, structured to meet their own particular needs.

FERC v. *Mississippi*, 456 U.S. at 767.

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* Other provisions of PURPA were sustained because they did nothing more than require that state adjudicatory processes be available on a nondiscriminatory basis. *See Testa* v. *Katt*, 330 U.S. 386 (1947).

The effect of Section 310(b)(1) stands in sharp contrast to the effect of PURPA examined in *FERC*. Section 310(b)(1) did not invite states to consider federal standards, but commanded compliance. Nor was there a hint of the co-operative federalism applauded in *FERC*. Congress, in passing PURPA, recognized that the States would be unlikely to want to forego energy regulation altogether, and so the statutory scheme envisioned a sharing of responsibility. If any state did not want to co-operate, it could abandon the field without sanction. Section 310(b)(1), on the other hand, mandated state action to meet a federal goal, with no shared responsibility, and imposed a sanction so harsh that states had no choice but to comply.

The Special Master recognized these intrusions into state processes. Nonetheless he suggested that Section 310(b)(1) could withstand constitutional challenge on several counts. First, after evaluating the intrusiveness of Section 310(b)(1) the Master found no reason for constitutional concern in this case because the burdens were "neither trivial nor extraordinary." (Report at 40). Second, the Master argued that because Congress could pre-empt the field entirely, it could regulate the states in the less intrusive method proposed by Section 310(b)(1). Quoting the Solicitor General's comparison of this case with *Garcia*, the Master stated:

> If Congress may directly regulate the wage and salary expenses incurred by the States in providing key government services . . . Congress may surely impose the far less significant compliance cost incurred by the states in issuing their bonds in registered form.

(Report at 123).

Both arguments fail and for the same reason: the Special Master failed to recognize that the nature of the federal intrusion in this case — the mandated co-option of state

governmental machinery — distinguishes this case from those that have preceded it.

When the Special Master found that the federal intrusion was neither "trivial nor extraordinary" he was referring to how much trouble it was to pass the laws in question and to implement them. But the Master misunderstood the constitutional significance of the intrusion by confusing its weight with its nature. It is not the ease *vel non* with which a state legislature may pass laws that is the measure of the federal intrusiveness, but whether the Constitution permits the federal government to command the States to pass any law at all.

The Master also missed the point in suggesting that because Congress could have directly regulated the interstate movement of bonds under the commerce clause,* the States have no cause for complaint when it took the less intrusive route provided by Section 310(b)(1). (Report at 128). The argument is flawed because Congress simply may not further a federal end by compelling the exercise of a state's sovereign powers.**

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* Reference to the commerce clause is unnecessary, as Congress could have accomplished the same result here with a regulation in aid of its taxing authority. Indeed, that is what NGA argues Congress should have done. *See infra* at 42.

** In advancing this argument the Master apparently relied on language in *FERC* that suggested Congress could, rather than pre-empting an area entirely, use a "lesser intrusion" of shared regulation. This concept of "cooperative federalism", whatever its application in *FERC*, is (as explained above) wholly inapposite here. In *FERC*, the intrusion was "lesser" because states were given an option of foregoing regulation entirely or of sharing responsibility. Here there was no option and no sharing. The States were told to meet the federal end and were forced to divert their own agenda to do so.

If Congress perceives a need for federal regulation it must, whenever possible, pursue that regulatory end using federal, and not state and local, means. In this case, for example, Congress could have addressed its tax evasion concerns in ways that did not require the commandeering of state legislative and administrative bodies. Congress could have forbidden the transfer of bearer bonds without the services of a broker. And, if Congress felt recordation of bonds was necessary, it could have enacted a federal mandate that all bearer municipal securities be immobilized in a securities depository. Both of these would have been more effective than registration, and neither would have intruded upon or diverted the states' governmental machinery.

D. In An Emergency, State Processes May Be Available For Federal Use

All of this is not to say that when other solutions are unavailable, Congress may not utilize state and local regulatory means: in the face of a national emergency, a temporary request for assistance from the states might be appropriate. For example, in *FERC* v. *Mississippi*, 456 U.S. 742, 745 (1981), discussed, *supra* at 35-40, the Court upheld Congressional legislation that was "designed to combat the nationwide energy crisis" and noted that Congress believed the legislation was "essential to the success of any effort to lessen the country's dependence on foreign oil, to avoid a repetition of the shortage of natural gas that had been experienced in 1977, and to control consumer costs." *Id.* at 746. And in *Fry* v. *United States*, 421 U.S. at 548, this Court upheld Congressional action freezing state wages on the grounds that the statute was an emergency measure essential "to counter severe inflation that threatened the national economy." *See also Case* v. *Bowles*, 327 U.S. 92, 101 (1946) (Court found that in time of war Congress could control the price of state timber sales to combat inflation).

The regulation of state government by Section 310(b)(6) was unjustified because even assuming tax evasion concerns

proffered by Congress, there were more than adequate means of meeting the problem without state involvement. As indicated earlier, (to choose one approach) Congress could have passed legislation requiring that bonds be transferred by brokers to retain negotiability. This would have been *more* effective than Section 310(b)(1), for all broker sales are reported to the Internal Revenue Service while no registered bond transfers through transfer agents are reported. With adequate national means at hand, state government cannot be co-opted.

This, then, is the foundation for our disagreement with the Special Master that the burdens imposed by Section 310(b)(1) were not constitutionally significant. The Master found the intrusion not unconstitutional because the weight of the intrusion was not "extraordinary;" but he did not examine the crucial issue whether the nature of the registration requirement invaded the States' separate and independent existence. Absent national emergency, the Constitution does not require extraordinary assumption of state and local government processes before this Court can address that intrusion.* Rather, the Constitution forbids Congressional regulation of a kind that commandeers state deliberative and administrative processes. When Congress imposes on the States in this way it deprives them of the ability to protect

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* This Court may step in before Congress literally legislates away the separate status of the state governments:

> [N]o one expects Congress to obliterate the states, at least in one fell swoop. If there is any danger, it lies in the tyranny of small decisions — in the prospect that Congress will nibble away at state sovereignty, bit by bit, until someday essentially nothing is left but a gutted shell.

L. Tribe, *American Constitutional Law* § 5-20 at 302 (1978).

themselves in the national political process. The intrusion represented by Section 310(b)(1) transgresses exactly those affirmative limits placed upon the national government by the constitutional plan.

CONCLUSION

For the foregoing reasons, the NGA requests that this Court find Section 310(b)(1) an unconstitutional exercise of Congress' power.

Respectfully submitted,

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May 9, 1987

INFORMATION REPORTING